ARE YOU CAUGHT IN THE STORM?: WHAT BANKRUPTCY TRUSTEES NEED TO KNOW ABOUT HURRICANE CLAIMS

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On the heels of last year's Hurricane Irma, everyone is mindful about the upcoming 2018 hurricane season. Last year, Hurricane Irma hit Florida and left about 65% of the state without power. In the months following the storm, businesses in the affected areas often struggled to recover, and it was a more difficult process for some more than for others. Those companies that have relied too much on leverage and stretched their borrowing to the limit may find it difficult to get back on their feet.

In fact, unforeseen catastrophes of this magnitude can cause ripple effects throughout the economy, all of which can add up to lower revenue and reduced cash flow for affected companies. Any scenario like that could spell disaster for a firm that is over-leveraged and doesn't have the flexibility to manage and deal with dramatic or unexpected change. If a company's balance sheet is adversely affected, due to too excessive leverage, it could be positioned for potential distress. If the distressed situation lasts too long because the company can't attract additional financing, or the insurance recoveries from the disaster take longer than expected, then the company may wind up in bankruptcy trying to negotiate with creditors.

With this is mind, debtors and trustees should review all insurance policies to assure that proper insurance is in place. A review of the applicable coverage exclusions, deductibles and post loss obligations should also be completed. Failure to comply with the policy's post loss obligations, such as providing prompt notice of a loss, can prejudice the right to recover damages. These are prudent steps to take as trustees and debtors in possession (DIP) are statutorily "accountable for all property received" by 11 U.S.C. § 704, which sets out the rights, powers and duties of a Chapter 7 and Chapter 11 trustee as well as a DIP. § 704(a)(2); § 1106(a)(1); § 1107(a).

Additionally, questions often arise regarding whether a trustee may treat insurance proceeds in a bank account as nonexempt funds or whether those funds should be treated as part of the homestead exemption. Under Florida law, the homestead exemption is liberally construed in favor of the exemption. As a result, insurance proceeds derived from damage to an exempt homestead most likely retain and enjoy homestead character, and are therefore exempt in bankruptcy cases. In re Crooks, 351 B.R. 783 (Bankr. M.D. Fla. 2006); In re Gilley, 236 B.R. 441, 445 (Bankr. M.D. Fla. 1999). This view appears to be shared with other jurisdictions that regularly face hurricanes, namely Texas. In In re Okwonna–Felix, No. 10–31663–H4–13, 2011 WL 3421561 at *7 (Bankr. S.D. Tex. 2011), a Texas Bankruptcy Court held that the debtor could exempt insurance proceeds from his Hurricane Ike claim under the federal "wild card" exemption provided by 11 U.S.C. § 522(d)(5), even though the debtor did not disclose the lawsuit or seek to exempt any recovery therefrom in his initial schedules. In the case of In re Hill, No. 08–36267, 2011 WL 6936357 at *10 (Bankr. S.D. Tex. 2011), the same court held that a debtor had the right to exempt settlement proceeds from his Hurricane Ike claim under Texas Homestead Law even though the debtor did not seek court authority to file the suit, did not request permission to hire a law firm to pursue the claim, did not list the lawsuit in the schedules, and did not seek court authority to enter into the settlement agreement.

It is also important for all hurricane claims to be disclosed. The case of Hadden v. State Farm Fire & Cas. Co., 37 So. 3d 918 (Fla. 5th DCA 2010), illustrates the trouble a policyholder can face if a hurricane claim is not properly disclosed. The insured in Hadden filed a lawsuit in state court for breach of contract against State Farm for property damage sustained from Hurricane Charley in August 2004. Unknown to his state court lawyer, the insured had already filed a pro se petition to declare bankruptcy several days earlier. State Farm raised an affirmative defense of judicial estoppel to the breach of contract case and the state trial court granted summary judgment in favor of State Farm on its judicial estoppel defense. State Farm asserted that the insured failed to properly disclose his insurance claim in the bankruptcy action, and could not pursue the state court action for damages. However, the debtor did make a disclosure in identifying a "hurricane insurance claim" in his bankruptcy schedules and also listed losses in his statement of financial affairs. On appeal, the Fifth District Court of Appeal ruled that the debtor's disclosures in the bankruptcy petition were sufficient to preclude the application of judicial estoppel in the case against State Farm because the information listed by the debtor created a factual issue regarding whether he maintained an inconsistent position in the bankruptcy proceeding that his State Farm action did not exist. The appellate court reversed the summary judgment and stated that it was improperly entered on judicial estoppel grounds. The Fifth District Court of Appeal also commented that the debtor may not have standing to pursue the lawsuit against State Farm due to the bankruptcy case. Upon the filing of a bankruptcy petition, the State Farm lawsuit became property of the bankruptcy estate, subject to the bankruptcy trustee's control and administration. The appellate court remanded the case to the state trial court with directions for the trial court to order that the bankruptcy court be notified of the lawsuit against State Farm. If State Farm remained unaware of the bankruptcy filing and the case proceeded to judgment or settlement, then that money would be subject to disgorgement by a bankruptcy trustee if that trustee later discovered the insurance claim. Also the attorneys who worked on the civil case may not get their fees paid because they did not have pre-approved court authority pursuant to 11 U.S.C. §§ 327 and 503.

It is incumbent on civil attorneys to ask their clients about any bankruptcy filings and to search the public records before filing civil suit. Trustees should investigate and inquire of debtors whether they have any pending hurricane insurance claims or have a right to file any pending hurricane insurance claim. This is especially true in the years after a damaging hurricane.

The 2018 hurricane season is here and if the predications come true, it can be an active one. Take the necessary steps now to avoid getting caught in the storm. If you have questions regarding your obligations as a debtor, trustee, or DIP, please contact attorneys Ilyse Homer or Ashley Dillman Bruce who represent clients in bankruptcy cases. If you have questions about your insurance coverage or other policy concerns, please contact Gina Clausen Lozier, a partner in our firm's Chambers rated Insurance Team.

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